INTERNAL REVENUE SERVICE

IRS News Release

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IRS Accepts Settlement Offer on Contingent Liability Tax Shelter

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WASHINGTON — The Internal Revenue Service announced today that it has successfully resolved a pending dispute with Hercules Incorporated, over a listed tax shelter transaction. This transaction, known as a contingent liability transaction, is at issue in a case pending in the United States Tax Court.

In Notice 2001-17, the Service listed the contingent liability transaction, and set forth the IRS's position that the strategy failed to comply with statutory requirements and lacked economic substance or effect. The contingent liability transaction was designed to shelter capital gains. In a typical contingent liability transaction, a taxpayer that has or anticipates a substantial capital gain transfers intercompany notes to a subsidiary in exchange for stock and the subsidiary's assumption of a contingent liability. The taxpayer claims that the basis in the stock received is equal to the value of the notes without reduction for the liability transferred. When the stock is sold, often to an accommodating party, the taxpayer claims a substantial loss that offsets unrelated capital gains. The taxpayer also claims deductions in later years when the liabilities are paid or incurred.

In 1999, prior to the publication of Notice 2001-17, Hercules engaged in a contingent liability transaction and claimed a $154 million capital loss. Hercules had received an opinion from its outside tax advisor that it was more likely than not to prevail if the issue were challenged on audit. Following an audit of the transaction, the IRS issued a statutory notice of deficiency in which it disallowed the claimed capital loss and determined penalties with respect to the transaction. In December 2003, Hercules filed a petition in the Tax Court challenging the tax deficiencies and related penalties.

Under the terms of the settlement, Hercules has agreed to concede 100% of the capital loss claimed from the stock sale, resulting in a tax liability of approximately $30 million, and to pay a 20% accuracy-related penalty of approximately $6 million. The Service has agreed not to pursue its claim for a 40% penalty for a gross valuation misstatement. Hercules has further agreed to a limited waiver of the taxpayer privacy and anti-disclosure rules in connection with this press release.

The resolution of the dispute with Hercules is part of the IRS's ongoing enforcement efforts and continuing commitment to aggressively resolve tax shelter transactions through responsible settlements, or litigation when necessary.

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Notwithstanding recent lower court losses in Black & Decker and Coltec, the Service continues to believe that the contingent liability transaction does not comply with the tax law. It will continue to pursue cases involving these transactions in the courts, where appropriate.

"Taxpayers should recognize that recent taxpayer victories at the trial court level have not deterred the IRS from taking a tough stance on listed transactions, both inside and outside of the courthouse," said IRS Chief Counsel Don Korb. "We are pleased that this taxpayer has chosen to put this shelter controversy behind it. The decision to accept Hercules' settlement offer reflects our commitment to resolving controversies involving listed transactions without litigation — provided the ultimate goal of enforcement is not compromised."

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